Journal of Business & Technology Law

Volume 3 | Issue 2 Article 15

Shutting the Door on Pension Fund Investment in Hedge Funds - Protecting Investors That Need Protection

Jonathan H. Bliley

JONATHAN H. BLILEY*

Shutting the Door on Pension Fund Investment in Hedge Funds—Protecting Investors That Need Protection

INTRODUCTION

HEDGE FUNDS HAVE BEEN THE SOURCE OF CONTROVERSY in recent time, especially in the wake of the failure of Amaranth Advisors, L.P. in September 2006.[1] Though the exact definition of a hedge fund still is unclear to many observers, a Securities and Exchange Commission (SEC) staff report defined a hedge fund as "an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company . . . ."[2] As this definition suggests, hedge funds are, for all practical purposes, unregulated and exempt from SEC disclosure and registration. This exemption permits funds to engage in risky trading activities, while potentially earning significantly higher returns than other investment entities like mutual funds.[3] Moreover, hedge funds are not required to disclose their trading strategies or the positions they take in the market.[4] In short, hedge funds are highly secretive investment vehicles.

Although hedge funds are risky investments, they provide an excellent risk/reward opportunity for many qualified, wealthy investors.[5] These funds have the potential to earn stellar returns for investors because of the lack of regulation. Thus, hedge funds should continue to be unregulated.[6]

While hedge funds should remain unregulated, and the SEC should not impose a blanket requirement for registration of them, something needs to be done to re-

* J.D., University of Maryland School of Law, 2008; B.A., Vanderbilt University, 2002.

1. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004); *see also* Ann Davis, Gregory Zuckerman & Henny Sender, *Hedge-Fund Hardball: Amid Amaranth's Crisis, Other Players*, WALL ST. J., Jan. 30, 2007, at A1.

2. Goldstein v. SEC, 451 F.3d 873, 875 (D.C. Cir. 2006).

3. *Id.* at 875–76. Mutual funds are prohibited, under the Investment Company Act of 1940, from engaging in volatile and risky trades, like derivatives. *Id.* Moreover, mutual funds are required to disclose to investors their investment strategies and the positions they take in the market. *Id.*

4. *Id.*

5. Chuck Jaffe, *New Hedge Fund Regulations Not Good Investment*, CHI. TRIB., Oct. 3, 2006, at B5; *see also* Editorial, *Targeting Hedge Funds*, WALL ST. J., Oct. 31, 2006, at A18.

6. Jaffe, *supra* note 5; *see also Targeting Hedge Funds*, *supra* note 5.

strict hedge funds from welcoming investment money from pension funds. Pension funds, which manage the retirement benefits for municipal employees, teachers, and the like, have found unregulated hedge funds as enticing vehicles for outstanding returns.[7] Yet, it is just the kind of people who rely on pension funds for retirement income that the securities laws were designed to protect through disclosure and regulation.[8]

Under the current structure, pension funds are permitted to invest in hedge funds without triggering registration requirements of securities laws because the alleged investment sophistication of the pension fund manager is imputed on all the pensioners.[9] Moreover, the pooled nature of its assets permits the pension fund to invest in vehicles for which the pensioners themselves would not have sufficient net worth.[10] But for the imputed sophistication, and pooled nature of the pension, these teachers and municipal employees would frustrate the exempt nature of the offering.[11] It is this fact that makes pension fund investment in hedge funds troubling.

As a group, teachers and municipal employees generally are not sophisticated investors. More importantly, they cannot afford to lose their retirement benefits. By investing in hedge funds, pension funds expose these peoples' retirement benefits to tremendous amounts of risk. Even more troubling is the fact that hedge funds have no disclosure requirements.[12] With no disclosure on a fund's positions and strategies, a pension fund is unable to assess the hedge funds' risk. The failure of Amaranth Advisors, L.P. serves as proof of this because the San Diego County Employees Retirement Association lost an estimated $87 million[13] as a result of an Amaranth trader who lost $6 billion dollars by taking the wrong position on natural gas prices.[14]

In the wake of Amaranth's implosion, this Comment discusses how regulators should limit pension funds (and the affiliated school teachers and municipal workers who rely on them) from being exposed to such risk without forcing general regulation on all hedge funds. One potential approach, which this Comment adopts, would require hedge funds to review the risk bearing ability of the investor when determining if the offering of limited partnership interests would frustrate the hedge fund's exemption from registering the fund and its securities (the Lim-

---

7. Greg Burns, *Pensions Betting on Hedge Funds*, CHI. TRIB., Jan. 26, 2007, at 1; Allan Sloan, *Amaranth's Wilting is a Lesson on Hedges*, WASH. POST, Sept. 26, 2006, at D2.

8. SEC v. Ralston Purina Co., 346 U.S. 119, 124–26 (1953).

9. *See infra* Part II.

10. *See* Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 684 n.15 (2000) (discussing how funds usually require each investor to have a minimum net worth minimum of $1 million).

11. *See infra* Part II.A.

12. *See infra* Part II.

13. Leslie Wolf Branscomb, *Treasurer Demands Accounting of County Pension System Losses*, SAN DIEGO UNION-TRIB., Oct. 4, 2006, at B2.

14. Comment, *Recipe for Sleepless Nights: Invest Blindly in a Hedge Fund*, FIN. TIMES (London), Sept. 23, 2006, at 11.

ited Partnership Interests) with the SEC.[15] Such an analysis could be applied to pension funds, the beneficiaries of which are not in a position to afford the loss of their investments, and either force hedge funds to reject such investors, or register the securities if they decide the investment is sufficiently worthwhile. This action is important given the growing allure of hedge fund returns enticing pension fund managers, especially where state and local governments refuse to inject money into under-funded pensions.[16]

I. HEDGE FUNDS AND THEIR RISK

A. *The Failure of Amaranth Advisors, L.P. and the Loss to Pension Funds*

Prior to September 2006, Amaranth Advisors, L.P. was considered a top hedge fund.[17] The fund originally was founded to follow a strategy of convertible bond arbitrage.[18] In the early 2000's, the fund decided to diversify into the energy market, a move considered "prescient" within the industry.[19] This exposure to energy markets benefited Amaranth with $1.26 billion in profits in 2005, and before the collapse in September, $2 billion in profits for 2006.[20]

In 2005, lured by this phenomenal growth, San Diego County Employees Retirement Association invested $175 million of the pension's money with Amaranth.[21] The pension's quest for such great profit, despite the substantial risk, resulted largely from the fund's need to alleviate a roughly $1 billion deficit from years of under-funding.[22]

Although Amaranth had a stellar year in 2005, much of its profit was due to energy trading.[23] Following this trend, the fund continued to place more of its assets into energy trading in 2006.[24] By July 2006, Amaranth had 56% of the fund's assets in the energy market.[25]

Brian Hunter, who specialized in natural gas futures, directed much of Amaranth's energy trading.[26] In August and September, however, Hunter's actions resulted in the fund losing $6 billion.[27] Hunter had bet big that the hurricane season

15. *See Position Papers Private Exemption Under Section 4(2) of the Securities Act of 1933*, 31 BUS. LAW. 483, 491–92 (1975).

16. Burns, *supra* note 7; Andrew Ross Sorkin, *A New Pension Game*, N.Y. TIMES, Oct. 8, 2006, § 3, at 4.

17. Susanne Craig, Randall Smith & Ann Davis, *Amaranth CEO Issues His Regrets*, WALL ST. J., Sept. 23, 2006, at B5.

18. *Recipe for Sleepless Nights*, *supra* note 14.

19. Craig, Smith & Davis, *supra* note 17.

20. *Id.*

21. Branscomb, *supra* note 13.

22. Opinion, *Extreme Caution; County Assuming Too High Hedge-Fund Risk*, SAN DIEGO UNION-TRIB., Nov. 13, 2006, at B6.

23. *Recipe for Sleepless Nights*, *supra* note 14.

24. *See* Davis, Zuckerman & Sender, *supra* note 1.

25. *Id.*

26. *Id.*

27. *Id.*

would result in a natural gas shortage, and thus a price spike.[28] This bet, however, proved wrong and fatal to the fund when prices did not spike.[29] Banks immediately issued margin demands, and Amaranth quickly found itself unable to meet these calls because the fund was so highly exposed to the energy sector.[30] The fund decided to wind down its affairs and, as of early 2007, was liquidating its assets.[31]

Initial estimates indicated that the San Diego County Employees Retirement Association would lose $105 million of its $175 million investment.[32] In January 2007, the pension fund recouped $48.2 million from Amaranth.[33] On March 29, 2007 the San Diego County Employees Retirement Association filed a civil suit against Amaranth in the Federal District Court for the Southern District of New York seeking damages for fraud, negligence, and breach of contract.[34]

B. *Amaranth Is Not Alone: The Volatility of Hedge Funds*

In the first half of 2006 alone, there were 326 hedge funds that went out of business.[35] Although these fund failures did not create front-page headlines, they serve to remind investors that hedge funds are risky investments. More recently, some hedge funds have suffered from overexposure to bad mortgages and other mortgage-related investments.[36] In May 2007, two Bear Stearns hedge funds lost approximately $1.6 billion of capital due to overexposure to bad mortgages.[37] Likewise, the Swiss banking firm UBS AG shut down a hedge fund in May 2007 that lost more than $124 million from similar bad investments.[38]

Furthermore, the risks associated with hedge funds seem to be increasing recently, as the market has become saturated with new funds.[39] Funds are unable to capitalize on cutting-edge and proprietary investment ideas with so many players in the field taking similar positions.[40] This competition forces funds to take much riskier positions than before in search of stellar returns.[41]

Perhaps the most notorious hedge fund failure was that of Long Term Capital Management ("Long Term") in 1998. In August of that year, following four years of

---

28. *Id.*
29. *Id.*
30. *Id.*
31. *Id.*
32. Branscomb, *supra* note 13.
33. *Id.*; *see also Retirement Group Sues Hedge Fund*, SAN DIEGO UNION-TRIB., Mar. 30, 2007, at B2.
34. *See* Complaint, San Diego Employees Ret. Ass'n v. Maounis et al., 1:07-CV-02618 (S.D.N.Y. Mar. 29, 2007).
35. Sloan, *supra* note 7.
36. Greg Ip & Jon E. Hilsenrath, *Debt Bomb: Inside the 'Subprime' Mortgage Debacle*, WALL ST. J., Aug. 7, 2007, at A1.
37. *Id.*
38. *Id.*
39. Anita Raghavan, Ianthe Jeanne Dugan & Gregory Zuckerman, *Despite Blue-Chip Gains, Hedge Funds Increasingly Are Faltering and Closing*, WALL ST. J., Oct. 4, 2006 at C1.
40. *Id.*
41. *Id.*

staggering returns that quadrupled the value of the fund, Long Term lost $553 million, or 15% of the fund's capital, in one day.[42] That one day loss came in the wake of having lost one-third of the fund's equity over the previous three months.[43] The root of this loss lay in Russia's default on its debt on August 17, 1998, which caused the price of public bonds to increase significantly and the price of corporate bonds to decrease substantially, as investors rushed to the safety of the United States Treasury instruments.[44] Long Term had taken a position on millions of bond contracts, believing that the difference between corporate and public bonds was never more than a certain percentage.[45] This assumption proved fatal to the fund, as the difference spiked following Russia's default.[46]

C. The Risks Manifested by These Past Incidents Serve as Warnings to Pension Funds

Despite the woes of Amaranth and the implosion at Long Term, pension funds recently have been migrating towards these risky investments in greater numbers. Like the San Diego County Employees Retirement Association, many pensions have invested in these vehicles due to pressures to increase returns in order to make up for under-funding.[47] In Illinois, the Teachers' Retirement System plans to invest $1 billion in hedge funds, despite the risk and lack of regulatory oversight.[48] The story in Illinois, as with so many other pension plans, revolves around the need to increase funding because the state government refuses to step in with financial assistance.[49]

As pensions continue to remain under-funded, their managers will continue to flock to hedge funds in hopes of stellar returns. Unlike wealthy investors, however, people relying on these pension funds for retirement cannot afford to lose money. Given the volatility and risk associated with hedge funds, it seems probable that another pension fund will suffer substantial losses just like San Diego County Employees Retirement Association.

---

42. *How LTCM Came to the Edge of the Abyss*, WALL ST. J., Sept. 11, 2000, at C1.

43. *Id.*

44. *Id.*; Diana B. Henriques, *Billions upon Billions*, N.Y. TIMES, Sept. 27, 1998, § 1, at 1.

45. Henriques, *supra* note 44.

46. *Id.* Out of fears that Long Term's failure would ruin the world's markets, as much of the fund's trading was done with money borrowed from various banks, the New York Federal Reserve engineered a buyout of Long Term by a consortium of the largest Investment Banks in September 1998. *Id.*; *see also How LTCM Came to the Edge of the Abyss*, *supra* note 42.

47. Sloan, *supra* note 7; Sorkin, *supra* note 16.

48. Burns, *supra* note 7.

49. *Id.*

II. THE SECURITIES LAWS AND HOW HEDGE FUNDS HAVE AVOIDED REGULATION

Federal securities laws were enacted in order "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[50] Hedge funds, however, are able to avoid the regulation of securities laws because they issue securities (interests in the fund) only "to those who are shown to be able to fend for themselves . . . ."[51] This lack of regulation is based upon the assumption that only sophisticated and well-heeled investors put money in these vehicles.[52] By only permitting wealthy, sophisticated investors to invest in the funds, hedge funds take advantage of several exemptions from registering set forth in the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. As such, hedge funds can take volatile investment positions and use risky investment strategies that regulated investment entities like mutual funds are prohibited from taking.

A. *Exemptions for Hedge Funds*

1. *The Non-Public Offering Exemption under the '33 Act and Reg. D*

The interests acquired when one invests in a hedge fund (limited partnership interests, and the like) are considered securities and must be registered with the SEC if they are offered or sold to the public.[53] Section 5 of the '33 Act states that the offer or sale of a security is unlawful unless that security has been registered.[54] However, hedge funds avoid registering the interests they sell to investors, and thus remain secretive and free from regulatory disclosure, through an exemption provided in section 4(2) of the '33 Act for non-public offerings.[55]

Regulation D of the '33 Act (Reg. D) and the rules provided for in that regulation, provide safe harbors for what may be considered a private offering for the purpose of section 4(2).[56] Specifically, Rule 506 under Reg. D exempts an issuer from registering securities so long as all purchasers are "accredited investors" or can prove they are "capable of evaluating the merits and risks of the prospective investments."[57] The issuer also must ensure that there are no more than thirty-five purchasers in an offering.[58] So long as a hedge fund sells the interests to accredited

50. SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953).

51. *Id.* at 126.

52. *See Targeting Hedge Funds*, *supra* note 5.

53. Applying the *Howey* test for determining if an instrument is a security to the interests acquired in a hedge fund, it is clear that there is an investment of money, in a common enterprise, with the expectation of profit, from the efforts of another. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

54. 15 U.S.C. § 77e(a) (2000).

55. *Id.* § 77d(2); Gibson, *supra* note 10, at 690–91.

56. 17 C.F.R. § 230.506 (2007). *See generally* Gibson, *supra* note 10.

57. 17 C.F.R. § 230.506.

58. *Id.*

investors, or those who can prove they have sufficient sophistication, the fund is exempt from the '33 Act's registration requirements.

Hedge funds are permitted to sell interests to pension funds under Rule 501, which provides a definition for "accredited investor."[59] Any plan established by state governments for the benefit of state employees is considered an accredited investor, so long as it has at least $5 million in total assets.[60] In effect, the purported investment knowledge and experience of the pension fund manager is imputed on the pension beneficiaries, who otherwise would not be considered accredited investors.

2. *Exemptions under the Investment Company Act of 1940*

In general terms, hedge funds are considered investment companies for the purposes of the Investment Company Act.[61] Hedge funds meet this definition because they are issuers whose primary business is the investing or trading in securities.[62] Investment companies are required to register with the SEC and are subject to many rules and regulations.[63] Most hedge funds, however, avoid registering under the Investment Company Act through an exemption for funds with fewer than 100 investors.[64]

3. *Exemptions under the Investment Advisers Act of 1940*

The Investment Advisers Act requires "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing, purchasing or selling securities . . . ." to register with the SEC.[65] Generally, hedge fund managers act as the general partner of a limited partnership, and each investor invests as a limited partner.[66] The fund manager, which provides investment advice to the hedge fund, satisfies the requirements of an investment adviser for the purposes of the Investment Advisers Act.[67] Like the other securities acts, the Investment Advisers Act provides an exemption from registering for certain investment advisers.[68] Specifically, advisers with less than fifteen clients are exempt from registering with the SEC.[69]

---

59. *Id.* § 230.501(a).
60. *Id.*
61. Gibson, *supra* note 10, at 693–94.
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*; 15 U.S.C. § 78c(a)(5) (2000).
66. Goldstein v. SEC, 451 F.3d 873, 876 (D.C. Cir. 2006).
67. *Id.*
68. *Id.*; *see also* Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004).
69. *Id.*

B. *The Effects of these Exemptions: Hedge Funds vs. Mutual Funds*

Mutual funds, unlike hedge funds, are heavily regulated by the SEC. Because mutual funds sell their interest to any and all investors, regardless of their sophistication, mutual funds are not able to take advantage of '33 Act exemptions, and must register their offerings.[70] Additionally, mutual funds must register under the Investment Company Act, since these funds, unlike hedge funds, generally have more than 100 investors.[71] Without the restrictions imposed upon registered investment entities, hedge funds are free to take much riskier investment positions than mutual funds, with the potential to earn substantially higher returns.

One major restriction placed upon mutual funds is the "undue use of leverage,"[72] or borrowing money "to improve one's speculative ability and to increase an investment's rate of return."[73] Mutual funds are required to maintain specified debt to asset ratios.[74] Perhaps the biggest implication of this restriction on the use of leverage is that mutual funds are prohibited from trading on margin and selling securities short.[75] Although not expressly prohibited, there is debate over whether mutual funds can invest in derivative instruments, given the leverage restrictions imposed by the Investment Company Act.[76]

In stark contrast, hedge funds make substantial profits by regularly using leverage.[77] Free from the restrictions from the Investment Company Act, hedge funds frequently purchase stock on margin.[78] Furthermore, hedge funds use leverage to their advantage by taking short positions on stock.[79] This freedom gives hedge funds the ability to earn substantial returns.[80] On the flip side, however, the ability to use leverage exposes hedge funds to tremendous amounts of risk because the fund must provide additional capital (a margin call) in the event the stock price goes down.[81] The more leveraged a fund is, the greater the chance that a fund is unable to meet margin calls.[82] If unable to make a margin call, the fund's position will be liquidated or the fund will be forced to liquidate other assets, resulting in loss to the fund much greater than the initial investment.[83]

---

70. Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 915 (2005).
71. *Id.*
72. *Id.* at 917.
73. BLACK'S LAW DICTIONARY 415 (2d Pocket ed. 2001).
74. Karmel, *supra* note 70, at 918.
75. *Id.*
76. *Id.*
77. Gibson, *supra* note 10, at 686.
78. *Id.*
79. *Id.*
80. *Id.* By using leverage, a hedge fund can purchase securities with much less money than the face value of the securities. Thus, if the stock price goes up, the fund can make a lot of profit with much less capital than otherwise would be required.
81. *Id.* at 688.
82. *Id.*; *see also* Davis, Zuckerman & Sender, *supra* note 1.
83. Gibson, *supra* note 10, at 688.

Additionally, the Investment Company Act imposes disclosure requirements on mutual funds. A mutual fund must disclose the fund's investment objectives[84] and the fund's "portfolio turnover" during the previous three years.[85] In short, mutual funds are prohibited from making dramatic and immediate changes in investment philosophy and allocation because investors have chosen a particular fund based upon a desire for certain kinds of exposure. Hedge funds, however, are not required to disclose investment philosophies or portfolio turnover as they are not governed by the Investment Company Act. Furthermore, hedge funds can change their investment positions very quickly to respond to changes in the markets, as Amaranth Advisors did when the convertible bond market went flat and the energy markets were booming.[86] In short, hedge funds are limited in their investment strategies only to the extent provided for in the partnership agreement signed by investors.[87]

III. EFFORTS TO REGULATE HEDGE FUNDS

The SEC became concerned with, among other things, the growth of pension fund investments in hedge funds and launched an investigation into hedge fund practices in 2002.[88] Following the investigation, and subsequent reports on the matter, the SEC proposed in July 2004 that the term "client" be defined to mean each limited partner in the hedge fund, for the purposes of the Investment Advisers Act.[89] Prior to this proposal, all hedge fund managers, acting as the General Partner of each fund, considered each hedge fund they managed as a single client, and were thus exempt from registering with the SEC because they each had less than fifteen hedge funds.[90] Following this proposal, however, the general partner of each fund would have to count each limited partner (investor) in the fund as a client.[91] The majority of hedge funds had more than fifteen limited partners, thus ensuring registration with the SEC of most funds.

The SEC adopted this proposed rule, following substantial commentary from lawyers and other industry participants, and it became effective in early 2005.[92] The rule was met with substantial controversy, as debates flared over whether the SEC should regulate hedge funds.[93] Soon after adoption, money manager Phillip Goldstein filed suit challenging this new rule.[94]

---

84. Karmel, *supra* note 70, at 918–19.
85. *Id.* at 919.
86. *See Recipe for Sleepless Nights*, *supra* note 14.
87. Karmel, *supra* note 70, at 924.
88. Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 69 Fed. Reg. 72,054, 72,057 (Dec. 10, 2004).
89. *Id.* at 72,058.
90. *Id.*
91. Goldstein v. SEC, 451 F.3d 873, 878 (D.C. Cir. 2006).
92. Registration Under the Advisers Act, 69 Fed. Reg. at 72,054, 72,058.
93. Kara Scannell, Deborah Solomon & Gregory Zuckerman, *Stop Order: SEC Dealt Setback as Court Rejects Hedge-Fund Rule*, WALL ST. J., June 24, 2006, at A1.
94. *Id.*

In June 2006, the United States Court of Appeals for the District of Columbia Circuit vacated the Hedge Fund Rule, finding that the rule was "arbitrary."[95] In the wake of this ruling, the SEC implemented a new rule prohibiting advisers to pooled investment vehicles from defrauding investors or prospective investors in pooled investment vehicles they advise.[96] Although this new rule grants the SEC power to go after hedge funds for fraud, without any disclosure requirements the regulators have no way of knowing if funds are acting fraudulently. As such, hedge funds remain unregulated, and the SEC still cannot protect pension fund investors unable to bear the risk of these investments vehicles.[97]

IV. AN ALTERNATIVE APPROACH TO PROTECTING PENSION FUND INVESTORS

Given the ever increasing investment by pension funds into hedge funds, coupled with the increasing volatility of hedge funds, reasonable safeguards are necessary to protect pensioners from the risk associated with these investment vehicles. Pensioners, who are typically state employees, are exactly those investors who securities laws were designed to protect. They generally lack the investment sophistication needed to gauge the risks involved with leverage, derivatives, and other practices of hedge funds. Most importantly, pensioners are not investors who can afford to lose money when hedge funds take high-risk positions or become too leveraged. The pensioners themselves rely heavily on the draws from the fund for retirement. Moreover, as local and state governments refuse to bail out these funds and as the funds remain severely under-funded, any further loss could be detrimental to the pensioners' ability to rely on the fund for retirement. This point, the general inability for pensions to bear the loss of the investment, likewise provides a viable alternative for protecting pension fund investors from the risky investments through the use of the '33 Act and Reg. D.

In the wake of *Goldstein*, the SEC has run into a potential roadblock in using the Investment Advisers Act to regulate hedge funds. The approach of the Hedge Fund Rule, which was rejected by the Court of Appeals, focused on regulating all hedge funds.[98] This approach, however, is unnecessary if the goal of the SEC is to protect unsophisticated or unknowing investors from the perils and risks associated with hedge funds. An alternative approach to regulating hedge funds, and one which would focus specifically on those investors the securities laws were designed to protect, flows from the private offering exemption under section 4(2) of the 33 Act and Rule 506 of Reg. D, which hedge funds have relied upon to exempt from registration the offering to investors of interests in the funds.

---

95. *Goldstein*, 451 F.3d at 883.

96. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756 (Aug. 9, 2007).

97. Scannell, Solomon & Zuckerman, *supra* note 93.

98. *See supra* Part II.

To protect pensioners from undue risk, the SEC could require hedge funds to apply a risk-bearing ability analysis of investors when determining whether an offering of securities is exempt from registration under section 4(2) of the '33 Act and Rule 506 of Reg. D. This approach to determining exemption was first set-forth in a Position Paper published by the Federal Regulation of Securities Committee, Section of Corporation, Banking and Business Law of the American Bar Association in 1975.[99] In this Position Paper, the committee suggested that an investor's ability to bear a loss could be an appropriate element in determining whether an offering of securities would be considered "public,"[100] and thus not exempt from registration under section 4(2).[101] The Committee found two important elements in analyzing an investor's risk bearing ability: (1) the amount of money invested, and (2) the level of risk associated with the investment.[102] Where a particular investor fails the risk bearing ability analysis, the issuer must either not offer the securities to this investor, or register the offering, as the offering would be public.

Applying this approach to hedge funds, in the initial offering of interests in the fund to investors, hedge fund managers would be required to analyze the investor's ability to bear the risk associated with the hedge fund. Funds could either refuse to offer the interests to the investors unable to bear the risk, since the offering would frustrate the private placement exemption, or could decide to register the interests to retain those investors. Most funds would probably prefer not to register, and thus would simply refuse to offer the interests to the investor.

In order to use this approach to protect pension funds beneficiaries, a hedge fund manager must determine whether the pension, which would otherwise be an accredited investor under Rule 501 of Reg. D, is unable to bear the risk associated with the investment. Given the under-funded status of many pensions and the increasing risk associated with hedge funds, it is reasonable to conclude that pension funds lack sufficient risk bearing ability to acquire interests in a hedge fund through a private placement without frustrating the issuer's exemption from registering. Indeed, hedge funds take extremely risky investment positions.[103] As evinced by Amaranth's failure and Long Term's demise, hedge funds that have historically strong returns can fail with any turn in the market.[104] Furthermore, the fact that so many of these funds fail establishes that hedge funds are very risky investments.[105]

99. *See generally Position Papers, supra* note 15.

100. In *Ralston Purina*, the Supreme Court determined that an offering is public if made to investors who are in need of the protection of the Securities Laws. 346 U.S. 119, 125–26 (1953).

101. *Position Papers, supra* note 15, at 491.

102. *Id.*

103. *See supra* Part II.B.

104. *See supra* Part II.

105. *See supra* Part II.

As such, an investment of interests in a hedge fund carries "a significant probability of total loss."[106]

Pension funds are in no position to risk the loss of large segments of their investments even in the face of potentially stellar returns. First, money in pension funds represent retirement earnings to real people. These people rely on this money to live during retirement. Any loss to a pension's assets could negatively impact pensioners who rely on this money, be it present drawers or employees who plan to retire in the future. That so many pensions are under-funded at the moment simply increases the risk that any loss of assets of the fund could adversely affect pensioners' ability to rely on the fund for retirement. Ironically, the strong earning potentials that lure so many pensions to hedge funds, sought to make up for severe deficits, could simply compound the funding problems of the pensions. Second, in light of the fact that state governments are refusing to provide additional funding for pensions, there exists no safety net for the funds. If a pension loses 10% of its assets through a hedge fund investment, that money probably is lost for good because the government may not assist the pension with shortfalls. As such, a pension fund would probably fail the risk bearing ability test, given the risk involved with hedge funds and the reliance by retirees on the pension, and would not qualify for a private offering of hedge fund interests.

One potential drawback of this approach arises for investments outside of the pension fund/hedge fund realm because it is unclear who must determine the risk-level of an investment. Should the onus be on issuers to pre-determine the level of risk associated with the securities being offered? One solution would be to rely on existing rating agencies like Moody's to make this determination.[107] Another solution to this issue, one that limits the application of the risk bearing analysis, would be to adopt the bright-line rule that this analysis is intended to apply only to investments by pension funds in hedge funds. Such a rule would eliminate the need for parties to make judgment calls as to the suitability of other investments.

CONCLUSION

Applying the risk bearing ability analysis to determine if a hedge fund's offering of interests frustrates the private placement exemption under section 4(2) of the '33 Act would provide an effective solution to the problem of pension funds investing

106. *Position Papers*, *supra* note 15, at 492. In its discussion of this analysis, the Committee suggested that an investor may be qualified for a private placement of high-mortgage bonds, but not qualified to invest in a private offering of "highly speculative common stock . . . [with] a significant probability of total loss." *Id.*

107. Given that the SEC already looks to ratings agencies, which are also called Nationally Recognized Statistical Rating Organizations, to determine the risk of default associated with debt securities, NRSROs would be the natural choice to quantify the risk associated with an investment in a hedge fund. *See* 17 C.F.R. § 240.15c3-1 (2007); *see also The Role of Credit Rating Agencies in the Structured Finance Market, Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 110th Cong. 133–35 (2007) (prepared statement of Julia M. Whitehead & H. Sean Mathis, Managing Director, Miller Mathis & Co., LLC).

in hedge funds. Because hedge funds are inherently risky investments, and pension funds are not in a position to suffer a total loss of an investment, hedge funds would not be permitted to offer interests to pension funds without frustrating the private nature of the offerings. At the same time, other wealthy and qualified investors, who are in a position to bear the risk of loss, could continue to invest in these funds without any oversight by the SEC. Furthermore, such an approach would not preclude pension funds from investing in hedge funds because the hedge fund could elect to register the interests under the '33 Act and sell them to pension funds. Electing to register the interests would subject the hedge funds to SEC oversight and disclosure rules. Such disclosure potentially could protect pension funds from substantial loss because hedge funds would be required to disclose their investment positions. If the hedge fund takes a position that is too risky, which is less likely if the fund must disclose its positions, the pension fund could withdraw its interests. As a result, this risk bearing ability analysis could protect pension funds from the risk of hedge funds without imposing unnecessary regulation and restrictions on other sophisticated market participants. Although not perfect, this approach at the very least provides a reasonable solution to a growing problem and is consistent with the original purpose of the securities laws—to protect unsophisticated investors through greater disclosure.